The Economic Club of New York

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The Honorable Alan Greenspan
Chairman of the Board of Governors
of the Federal Reserve System
of the United States

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Introduction

John M. Hennessy, Chairman

Ladies and gentlemen, good evening. I am Jack Hennessy and it gives me great pleasure to extend a very, very warm welcome to all of you, to the 345th meeting in the 88th year of the Economic Club of New York. Tonight we have a very special program which is obvious to anyone who is in the room, by the turnout and the electricity and the excitement in the air. As the saying goes, tonight our guest of honor needs no introduction, particularly to this New York audience. What I thought I would do is perhaps just make it a homecoming. This is a hometown boy that made good, and I thought I would dwell on a couple of facts that may not be as well-known as his current elevated position.

First and probably the most important part is that Alan in 1987 had to make one of the most difficult decisions in his whole life, he confirmed this to me tonight. He was Vice Chairman at that time of the Economic Club of New York. He was next in line for the Chairmanship, and he had to choose between that post and becoming Chairman of the Federal Reserve. He was born right here in New York City. He has markets in his blood, in the genes. His father was a stockbroker. So he is no ordinary Governor, Chairman of the Federal Reserve. He does intuitively understand markets. As a child he was a bit of a numbers freak, may be too strong a word, but he did like to do calculations in his head. He could reel off the batting average of all of the major league batters at the age of 7 or 8. And not only was he good with numbers, but when he graduated from high school he and Leonard Garment took two years off and they toured America. They were professionals, not economists, but they played with the Henry Jerome Band as professional musicians and our guest was both the clarinet and the tenor sax player. He did go to school in New York. He is a double graduate of NYU. He has a BA, summa cum laude and an MA in Economics from NYU. Then he did graduate work at Columbia. Where he caught the eye and became a prodigy and very close friend in time of a former Fed Chairman, Professor Arthur Burns. He also has a long and distinguished record as a person who knows what a bottom line is, he ran Townsend-Greenspan, a very successful economic consulting firm over many years and he sat on a lot of corporate boards, Capital Cities, General Foods, JP Morgan, Mobile Oil. And I think in the last couple of decades he established himself as the premier economic policy leader, commuting literally back and forth between the private and public sector. He served as an informal advisor to President Nixon; he was Chairman of President Ford's Council of Economic Advisors. President Reagan gave him the important task of Chairing the Commission that defies the solution, in the early 1980's, of the reform of the Social Security System and really saved it from insolvency. And then of course, as you all know, he was picked by President Reagan in 1987 to succeed Paul Volcker as Chairman of the Fed. In that position, which most of us rank at least in this room, as second only to the Good Lord, (laughter) he has won just enormous respect here and around the world for his integrity, his professionalism, and he is a strong believe, he is a guardian of the strong dollar, of a stable dollar. He is the watchdog over our economy and the pilot we are all counting on for that very smooth and we hope very soft landing. Now for 300 years the Governor of the Bank of England regulated markets by either raising his right eyebrow or lowering it. And to our guest speaker tonight, I would like to say, we are all hoping your right eyebrow is going to be lower than higher at the end of your speech. (Laughter) Please all join me in giving a very warm welcome to the Chairman of the Board of Governors, of the Federal Reserve System of the United States, the Honorable Alan Greenspan. (Applause)

The Honorable Alan Greenspan

Chairman of the Board of Governors

of the Federal Reserve System of the United States

That was very nice, and I am terribly sorry you stopped. It was getting better as it was going on. I must say that coming back here is always a sense of homecoming, as Jack indicated, I have been an active member of this Club, or was, for many years, and an interested audience on occasions such as these, so I was glad to get your invitation some months ago to appear again on the other side of the dais, sort to speak.

In looking over the list of people in this particular club, I have learned that after I left the Vice Presidency, or rather the Vice Chairmanship of this organization, was retired, and I assume that, or I would like to believe, that it had something to do with that event many years ago when Babe Ruth’s number 3 was retired, because you couldn’t fill it up, in any particular way, unfortunately my evidence that, that is true is really very minute to nonexistent.

It has really been an extraordinary two years since I last addressed this Club and obviously much has happened since. My main topic for this meeting is the evolving global financial environment and its implications for central banks. One of the most significant implications of the globalization process has been to increase the importance of consistently following disciplined macroeconomic policies to promote stable economies. In this regard I thought it might appropriate to take a few minutes at the outset of my remarks this evening to review the current situation in the United States. As you know, the Federal Reserve began to tighten monetary policy in February 1994. By that time evidence became increasingly persuasive that the financial strains that earlier had been holding back economic expansion had eased considerably. Borrower and lender Balance Sheets and Income Statements had improved markedly and credit was readily available and increasingly used. Improving financial conditions were accompanied by a considerable strengthening of economic growth and a more rapid rise in levels of resource utilization. Under these circumstances, if policy weren't tightened at an early time, the likely result would have been an unsustainable pace of expansion and mounting inflationary pressures, which would unleash destabilizing forces in the economy.

By 1995 the monetary tightening began to damp the increase in underlying demand. This year has seen an appreciable slowing in the rate of growth of final sales from the torrid pace of 1994 and production adjustments to control inventory levels. A moderation in growth was inevitable and desirable as the economy began to operate in the neighborhood of its long-term productive potential.

The longer it was delayed, the more severe the subsequent correction and output was likely to be owing in part to the increasing risks of a major inventory buildup that would have to be reversed. The process of slowing to a more sustainable pace has not been entirely smooth. Anyone who thought it would be is not a very close student of economic history or of human nature. As I have indicated, over the past several weeks, incoming information on the forces involved does suggest some increased risk of a modest near term recession. But the early onset of this process of moderation also indicates markedly reduced prospects for a more severe inventory induced downturn later.

It is difficult at this point to judge with any confidence how these various forces will work themselves out in the period ahead. The pattern of inventory investment is crucial to the outlook. In recent years improvements in technology and procedures have helped the managers of American business operate with increasingly leaner inventories. This was reflected in a fairly dramatic decline in inventory sales ratios from the early 1990's into 1994. But there was obviously a limit to how far these ratios could be compressed without further technological improvements and once the ratios flattened out last year, continuing robust sales growth necessarily led to a much higher rate of inventory investment. With sales growth slowing this year, overall inventory sales ratios have increased slightly and a few key industries have found themselves with troubling overhangs. But aggregate ratios are still low by historic standards and the prospects of a substantial inventory liquidation, which characterized many of the sharp post-war contractions, seem limited. Although inventory investment patterns are likely to dominate near-term fluctuations in activity, it is final sales that provide the underpinnings for sustained growth. Movements in financial markets recently, along with ample credit availability should help support underlying demand going forward. Nonetheless uncertainties abound. In part they arise from the inventory adjustment itself, which can feed back on final sales. Ideally production adjustments should quickly shut off unintended inventory accumulation, avoiding a prolonged period of weakness that could adversely affect business and consumer confidence and spending plans.

But the ideal and the real often do not converge. Moreover, demand can be buffeted by a number of other factors including importantly, in current circumstances, evolving fiscal policy and economic conditions abroad. A complex business cycle process is underway, whose outcome is yet to be determined. For the Federal Reserve it is a time for intensifying our normal surveillance and analysis of ongoing developments to gauge whether policy still is appropriately positioned to foster a sustained economic expansion.

Of one thing I am certain, our Federal Open Market Committee Meeting in a couple of weeks will be most engaging. (Laughter) I am also confident that the consideration given to the ____ policy will be in the context of our longer term goal of price stability. A consistently disciplined monetary policy is what our global financial system increasingly requires and rewards. This system also requires and rewards a disciplined fiscal policy. And in this fear, the prospects in the United States are clearly improving.

Both Congress and the President have committed themselves to reach budget balance early in the next decade. Of course, too often in the past, good intentions have gone by the boards when specific program initiatives meet constituency pressures. But I am encouraged that these are serious efforts and offer the best chance in many years to put in place a sensible budget policy. The rewards of success would be subtle but ultimately substantial. Removing the debilitating overhang of budget deficits from our entrepreneurial business system will free resources to engage in expanded wealth creation. A more sustainable pattern of domestic saving and spending would promote lower interest rates and add to the trend of economic growth we bequeath the following generations.

Reducing the demands of the United States on worldwide savings to finance our deficit would also remove a potentially destabilizing question mark over global financial markets. Removing this possible source of disruption has become increasingly important as global markets have evolved rapidly in recent years taking a more prominent role in our economic lives. As a result of changes in communications and information technology, and the new instruments and risk management techniques they have made possible, financial markets undoubtedly are far more efficient today than ever before. In particular, an ever wider range of financial and nonfinancial firms today can manage their financial risks quite effectively, allowing them to concentrate on managing the economic risks associated with their primary businesses. Still for central bankers with responsibilities for financial market stability, the new technologies and new instruments have presented new challenges. Some argue that market dynamics have been altered in ways that increase the likelihood of significant market disruptions. Whatever the merits of this argument, there is a clear sense that the new technologies and the financial instruments and techniques they have made possible, have strengthened interdependencies among markets and market participants, both within and across national boundaries. As a result, a disturbance in one market segment or one country is likely to be transmitted far more rapidly throughout the world economy. This tendency poses a number of challenges to central banks as they discharge their responsibility for the stability of the world's interdependent financial system.

It wasn't always thus. In earlier generations, information moved slowly, constrained by the state of communications technology. Financial crises in the early 19th century, for example, particularly those associated with the Napoleonic Wars were often related to military and other events in faraway places. A European or American investor speculative position could be wiped out by a military setback and he might not even know about it for days or even weeks; which from a prospective of central banking today might be considered bliss. (Laughter)

As the 19th century unfolded, communications speeded up. By the turn of the century events moved more rapidly but their speed was at most a crawl by the standard of today's financial markets. The environment now facing the world's central banks and of course private participants in financial markets as well, is characterized by instant communication. Complex financial instruments, derivative instruments in one form or another are being developed to take advantage of the gains in communications and information technology. Such instruments would not have flourished as they have without the technological advances of the past several decades. They could not be priced properly, the markets they involve could not be arbitraged properly and the risks they give rise to could not be managed at all to say nothing of properly without high powered data processing and communications capabilities.

Finance of course is not an end in itself. It is the institutional structure that we have developed over the centuries to facilitate the production of goods and services. Accordingly to understand better the evolution of today's burgeoning global financial markets we need first to understand the extraordinary changes that have emerged in the past century or more in what we conventionally call the real side of our economies, the production of goods and services. The same technological forces currently driving finance were first evident in the production process and have had a profound affect on what we produce and how we do it. Technological change or more generally, ideas, have significantly altered the nature of output so that it has become increasingly conceptual and less physical. A much smaller proportion of the measured real gross domestic product constitutes physical bulk today than in past generations. As the relative cost of transporting goods falls dramatically as a consequence of this physical downsizing, the conceptual content of output becomes a major factor in the increasingly rapid globalization of merchandise trade. Obviously the less the bulk, and the lower the weight, the easier goods are to move, especially over long distances and across national boundaries. Thus, in the United States we have estimated that after we adjust for average price changes, pounds shipped per real dollar of both U.S. exports and imports, are now less than half of what they were in 1970.

The downsizing of American trade is of course a reflection of the extent to which conceptualization is also dominating the economies of our trading partners throughout the world. Not inconsequentially downsizing has extraordinary implications for our environment since it is the extensive use of physical resources that has created much of our pollution and waste disposal difficulties as our populations have increased.

Of course, a significant part of the pronounced expansion in international trade has resulted from the breaking down of trade barriers over the years, but the political processes that have led in that direction to a significant extent have been pushed by the technological changes in the composition of goods and services.

Not unexpectedly as goods and services have moved across borders, the necessity to finance them has increased dramatically. But what is particularly startling is how large the expansion in cross border finance has become, relative to the trade it finances. To be sure, much cross border finance supports investment portfolios, doubtless some largely speculative. But in the end, even they are part of the support systems for efficient international movement of goods and services.

The relative expansion and cross border financial transactions is in fact another manifestation of conceptual trade as a single financial product is broken into many pieces that in turn are traded. Specifically over the decade 1983 through 1993, world trade measured in nominal dollars increased by about 125%. But the increase in the stock of cross border bank assets, bond and stock issuance, and derivatives was several multiples greater. Such rapid growth, however measured, should not be surprising given the extent to which low cost information processing and communications technology have improved the ability of customers in one part of the world to avail themselves of borrowing, depositing or risk management opportunities offered anywhere in the world on a real-time basis.

These developments enhance the process, whereby an excess of saving over investment in one country finds an appropriate outlet in another. In short, they facilitate the drive to equate risk adjusted rates of return on investments worldwide. They thereby improve the worldwide allocation of scarce capital and in the process engender a huge increase in opportunities for risk dispersion and hedging.

The evolving nature of the financing of expanding cross border trade suggests the potential for a far larger world financial system than currently exists. If we can resist protectionist pressures in our societies, in the financial arena as well as in the interchange of physical goods, we can look forward to the benefits of the international division of labor on a much larger scale in the 21st century. What we don't know for sure, but strongly suspect, is that the accelerating expansion of global finance may be indispensable to the continued rapid growth in world trade in goods and services. It is becoming increasingly evident that many layers of financial intermediation will be required if we are to capture the full benefits of our advances in finance. Certainly the emergence of a highly liquid foreign exchange market has facilitated basic foreign exchange transactions and the availability of more complex hedging strategies enables producers and investors to achieve their desired risk positions.

This owes largely to the ability of modern financial products to unbundle complex risks in ways that enable each counter party to choose the combination of risks necessary to advance its business strategy and to eschew those that do not. This process enhances cross border trade in goods and services, facilitates cross border portfolio investment strategies, enhances the lower cost financing of real capital formation on a worldwide basis and hence leads to an expansion of international trade and rising standards of living.

But achieving those benefits surely will require the maintenance of a stable macroeconomic environment. An environment conducive to stable product prices and to maintaining sustainable economic growth is a central responsibility of central banks. How well we do our job has implications for participants in financial markets because we provide the backdrop against which individual market participants make their decisions. Perhaps the most important development in recent years has been the shift from an environment of inflationary expectations built into both business planning and financial contracts toward an environment of lower inflation. It is important that progress continue.

Few now question the overall benefits for economic growth and stability of the dramatic slowing in the rate of price inflation on a worldwide basis over the past decade. Fewer should question the need to maintain a credible long run commitment to price stability. A consensus has developed among monetary authorities in most countries which is spreading to many developing countries as well, about the need to maintain a non-inflationary environment in order to achieve maximum sustainable growth. The statement in the communique issued following a meeting of G7 Finance Ministers and Central Bank Governors at the end of this past April that “Considerable progress has been made in establishing the conditions conducive to achievement and maintenance of price stability” and similar references to non-inflationary growth in the communique issued following last week’s Halifax Summit, reflect this emergence of convergence of views about a long-term focus on achieving price stability.

In the context of rapid changes affecting financial markets, disruptions are inevitable. The economic consequences of these disruptions will be minimized if they are not further compounded by financial instability associated with fluctuations in underlying inflation trends. Thus, as international financial markets continue to expand, central banks have twin objectives; achieving macroeconomic stability and maintaining safe and sound financial institutions that can take advantage of stability while exploiting the inevitable new technological advances.

The changing dynamics of modern global financial systems requires that central banks address the inevitable increase of potential systemic risk. It is probably fair to say that the very efficiency of global financial markets engendered by the rapid proliferation of financial products also has the capability of transmitting mistakes at a far faster pace throughout the financial system in ways that were unknown a generation ago and not even remotely imagined in the 19th century.

Certainly the Baring Brothers episode shows that large losses can be created quite efficiently. (Laughter) Today's technology enables single individuals to initiate massive transactions with very rapid execution. Clearly not only has the productivity of global finance increased markedly, but so obviously has the ability to generate losses at a previously inconceivable rate. Moreover increasing global financial efficiency by creating the mechanisms for mistakes to ricochet throughout the global financial system has patently increased the potential for systemic risk.

Why not, then one might ask, bar or contain the expansion of global finance by capital controls, transaction taxes or other market inhibiting initiatives? Why not, return to the less hectic and seemingly less threatening markets of earlier years? Endeavoring to thwart technological advance and new knowledge and innovation through the erection of barriers to the spread of knowledge would as history amply demonstrates have large, perhaps adverse, unintended consequences. Suppressed markets in one location would be rapidly displaced by others outside the reach of government controls and taxes. Of far greater importance, risk taking, would be suppressed. Without enterprises being willing to commit resources to an uncertain future on the basis of a new idea, wealth creation to enhance living standards is not possible. We cannot turn back the clock and we should not try to do so. Rather we should recognize that if it is technology that has imparted the current stress to markets, technology can be employed to contain it. Enhancements to financial institutions internal risk management systems arguably constitute the most effective countermeasure to the increased potential instability of the global financial system. The availability of new technology and new derivative financial instruments can...clearly has facilitated new, more rigorous approaches to the conceptualization measurement and management of risk to such systems.

There are, however, limitations to the statistical models used in such systems, owing to the necessity of overly simplifying assumptions. Hence, human judgements based on analytically looser but far more realistic and comprehensive evaluations of what the future may hold are of critical importance in risk management. Although a sophisticated understanding of statistical modeling techniques is important to risk management, an intimate knowledge of the markets in which an institution trades, and of the customers it serves, is turning out to be far more important.

In one sense risk management systems were exposed to a very severe real life stress test in 1994 when sharp increases in interest rates created large losses in fixed income markets. As a consequence, firm's models and judgments should be sounder today than those that prevailed in early 1994. But the Barings episode suggests that further improvements to internal risk management systems, as well as internal controls are needed; in some instances very significant improvements.

As recent history also demonstrates, the key danger is that large and rapid movements of portfolio capital have the potential to disrupt the central market mechanisms for insuring financial contract performance. If a spasm of selling cannot readily be absorbed because of payment and settlement system inadequacies, uncertainties accelerate inducing additional spasms and a broadening contagion of the disruption. If the central market mechanisms hold up, and liquidity of underlying markets is preserved, risk management failures at individual institutions are unlikely to give rise to systemic problems.

For example, the failure of Baring Brothers did not create systemic problems because the Asian Future Clearing Houses continued to meet their obligations, albeit with difficulty and the liquidity of the underlying markets for Japanese stocks and bonds were not significantly impaired.

Experience with other recent market events supports the same conclusions. Several studies of the 1987 stock market crash concluded that the greatest threat to the liquidity of the markets during that turbulent period was the potential for a default by a major participant in the settlement systems for equity or equity derivatives.

Again in 1990 the most serious threats to the orderly liquidation of Drexel Burnham Lambert Group were posed by weaknesses in settlement arrangements. Fortunately significant changes in payment systems are on the horizon that will allow security settlement systems to be strengthened and thereby lessen the likelihood of a loss of market liquidity.

In particular the Central Banks of the European Union countries are publically committed to developing real time, gross settlement systems for large volume payments as soon as possible. This will create new opportunities for depositories in these countries to redesign their securities transfer systems as real time gross settlement systems or as net settlement systems with multiple settlements throughout the day. If depositories wish to take advantage of such opportunities, however, they will need to rethink fundamentally the design and operation of their systems, including their ability to complete settlements in the event of a default by a major participant.

Central banks also have a key role to play in dealing with potential new sources of risk and of the transmission of shocks in financial markets. Recognizing the increasingly interconnected nature of financial markets; central banks of various countries are working together to provide guides for the development of safer payment systems. In the bank supervisory area we are extending capital requirements for commercial banks to cover a broader array of risks and in the process utilizing the new technologies in the private sector to assess vulnerability of portfolio configurations.

In these and other ways we must ensure that our rapidly changing global financial system retains the capacity to contain market shocks. This is a never ending process, which will require vigilance on the part of both private market participants and public regulatory authorities.

In summary, recent events have taught us once again that the global nature of trade and goods, services, and financial instruments, exerts an exacting discipline on the behavior of central banks. Technology has defeated distance by slashing the costs of gathering information and of transacting. Advances in computing and financial engineering during the past 10 or 15 years has enabled investors and speculators to choose among a wide array of investment instruments allowing them to manage risks better and when they chose to exert their notions about future market movements forcefully through the use of leverage. The former improved risk management has done much to make markets more resilient while the latter, easier recourse to leverage, may add to the volatility of financial prices at time. These developments have freed up the flow of international capital, thus potentially improving the efficiency of the allocation of the world's resources and raising world's living standards. They have also permitted markets to respond more quickly and with greater force to a countries macroeconomic policies. This puts a special burden on the Federal Reserve because the U.S. dollar is effectively the key reserve currency of the world trading system. In that role, we enjoy an increasing demand for our financial instruments. However, this role also heightens the share of the demand for dollar assets that is related to more volatile portfolio motives.

The new world of financial trading can punish policy misalignments with amazing alacrity. This is a lesson repeated time and again, taught in recent years by for example the breakdown of the European Exchange Rate Mechanism in 1992 and the plunge in the exchange value of the peso at the end of 1994 and early 1995. In the process of pursuing their domestic objectives, central banks cannot be indifferent to the signals coming from international financial markets. Although markets can be harsh teachers at times, the constraints that they impose discipline our policy choices and remind us every day of our longer run responsibilities.

While there are many policy considerations that arise as a consequence of the rapidly expanding global financial system, the most important is the necessity of maintaining stability in the prices of goods and services and confidence in domestic financial markets. Failure to do so is apt to exact far greater consequences as a result of cross-border capital movements that those which might have prevailed, say a generation or so ago.

Thank you very much. It is a pleasure being with you. (Applause) And I look forward to fencing with my old colleagues.

QUESTION AND ANSWER PERIOD

JOHN M. HENNESSY, CHAIRMAN: As you all know, the tradition of the Club now is to have a 30 minute period of questions and we have two predesignated questioners tonight, Martin Davis, who is the Managing Director and Chief Executive of Wellspring Associates. And Henry Kaufman, President of Henry Kaufman Associates. They will be our surrogates in drilling Alan here. Marty, do you want to start off.

MARTIN DAVIS: Mr. Chairman, I believe there is one question uppermost in everyone's mind tonight, and if I may be bold enough to ask, will you or won't you and if not, why not, and if so, why, (laughter and applause) ....

THE HONORABLE ALAN GREENSPAN: Yes and no. (Laughter) Let me put it this way, I spend a substantial amount of my time in endeavoring to fend off questions and worry terribly that I might end up being too clear. (Laughter and applause) What I have learned at the Federal Reserve is a new language which is called Fed Speak. Here we learn to mumble with great incoherence and when confronted with a question like that Martin, that I get my little lexicon out very quickly, and read how to answer your question, so I hope I didn't answer it. (Laughter) I am sure you will ask an equivalent again.

HENRY KAUFMAN: We didn't get far on that one. (Laughter) Let me change the subject for a minute to Mr. Chairman, there has been a lot of talk about balancing the budget over the next seven to ten years and as you know, this is a long time during which economic life, political life, and many circumstances can change, so perhaps I would like you to focus on the immediate budgetary outlook. From your perspective, let's say over the next one and a half years, what would you deem to be an appropriate fiscal policy posture?

THE HONORABLE ALAN GREENSPAN: Well Henry, first of all let me just say I agree with you with your initial premise that as one gets out into the future, it is rather difficult to commit successive Congresses and Administrations to policies which were implemented earlier.

However I do believe that what is driving the overall fiscal debate today is a v very extraordinary change amongst the electorate of this country. And I suspect that what we are observing is not some minor transitional fact which could very readily be reversed quickly. I frankly doubt that. I think that there is a fundamental change which is very likely to continue on for a good period of years and even though it is difficult to project how the budget will move in the next seven to ten years, I think it will be driven to a very substantial extent by this change in attitudes on the part of the American people with respect to fiscal finance, having observed the corrosive effects that the lack of proper fiscal finance has created. So leaving aside the longer term which I think is more an issue of an evaluation of the conceptual and cultural framework of the United States, with respect to the specific question, I would frankly like to see as much deficit reduction as possible, as quickly as possible, and as indeed I answered to a question in the Senate this morning when somebody recalled that I had said that I cannot imagine staying up at night being concerned that the Congress or the Government will cut budget deficits too quickly, the truth of the matter is, I cannot, because if there is a very large cut, and I suspect that there is a much greater probability in today's environment than in any recent period, my own expectations as I have stated on many times in the past, is that long-term interest rates will fall if those cuts are credible. And I emphasize the credible. If it turns out that there is a very substantial so called fiscal drag which is very substantially in excess of the positive expansionary forces that would occur as a consequence of the decline in long-term interest rates for example, that is the type of reaction in the marketplace which central banks respond to. We don't respond in advance, particularly, what we respond to is an evaluation of the processes that are going on in the marketplace in the economy in finance and to that extent, I must say to you that since I have considered for many years, this problem of the budget deficit as being an extraordinarily corrosive force, being tooted to a large extent by Peter Peterson sitting next to me right here. I would think that, I would not be concerned about how large a cut in the deficit is made, my view, the larger the better at this point. (Applause)

MARTIN DAVIS: Mr. Chairman we are seeing a renewed interest in a flat tax and in a possible consumption tax. Most tax payers do think a sweeping change in tax policy warrants serious attention. Since the momentum seems to be growing on flat tax proposals, has the Fed done any analysis of its possible effect, and in general, the economic need to modernize and rationalize our tax system?

THE HONORABLE ALAN GREENSPAN: We haven’t done anything officially in the sense that there is no particular statute in front of us which we have been asked to comment on, but there is a general view, I think amongst economists in and out of government, that there is a considerable deficiency of savings in this society. It has not always been the case. It is hard to recall this, but in the period moving around the turn of the century through the 1920's, the United States was the largest saver in the world, and indeed that is how we move to the highest standard of living in the world. The fact that we have now developed a far smaller propensity to save is I think a very important negative in the longer term outlook and one which I think we must address as quickly as we can. And I might say, coming to grips with the budget deficit is one way of doing this, since you reduce the drain on private savings, and the net affect is positive. But, clearly to the extent that you can create a tax system which discourages consumption, which by definition increases savings, clearly most economists would argue that is an appropriate thing to do. There are very considerable difficulties in any reform of the tax system because it gets to the root of the whole notion of equity, fairness and the distributions of income after tax. So there is a far more involved in this type of analysis than economists points of view. The whole society is brought to bear on this issue. I cannot really say to you that this is something that is about to change very quickly, but I am impressed with the growing desire on the part of a lot of persons in the Congress, both Democrat and Republican who are thinking that the existing tax system is just too cumbersome. It has too much in the way of costs involved in meeting it and I would suspect that over the years, to the same extent that this move towards budget balance is gathering strength in our society, I think we are also going to begin to see something moving, I don't know whether it is a flat tax, or a value added tax or a national sales tax, they all have good and bad aspects to them. They will be debated very considerably. The important issue is that is likely to happen where even the debate did not take place a decade or two ago.

HENRY KAUFMAN: Mr. Chairman, do you still favor a formal inflationary target for the United States, and with that in mind, let me just indicate that the core CPI thus far this year has risen about 3.5% at an annual rate. It rose about 2.7% last year, and therefore, if we had a formal inflationary target would today's inflation rate be over the limit?

THE HONORABLE ALAN GREENSPAN: Well first let me say that I am in general sympathetic to the view that we have to think in terms of some set of not necessarily in numerical targets but qualitative targets. For example, if you look at the current situation, to take your numbers very specifically, it is certainly true that if you look at the inflation figures that exist, whether you are looking at the core data, the overall data, what we are seeing is some modest acceleration. But if you look at the underlying data as I know you know as well as anybody, that what we are seeing, at this particular stage is the afterglow or the very substantial economic expansion which slowed down very dramatically earlier this year. But what has been carried into 1995 is a very significant amount of underlying cost structure which was evolving during 1994 specifically and which manifests itself in higher prices in the earlier months of 1995. In 1994 when these major cost increases were taking place, rapid increases in productivity enabled those cost increases to be absorbed in a manner which did not work their way through into final prices. What is happening now is that with the economy slowing down and productivity slowing down largely because you can't distribute fixed costs as easily in a slowing economy as in a rapidly growing economy, the cost absorption is no longer as large as it was and more of the internal intermediate and raw material price increases are moving through into the price level. However, I do think that as we look in the forward period, it is increasingly clear, especially in the last month or two, that the underlying inflationary pressures are very clearly easing. And therefore, if one were to have say, some form of formal targeting of some forward positions with respect to monetary policy, I would have difficulty in trying to decide between, it is obviously far more important for public policy and public perception to have specific numbers out there. But as a central banker, I think that if our longer term purpose is to keep the inflation rate down and gradually over the longer run move towards price stability, I think the issue is made more complex if we have rigid guidelines. So while I am very sympathetic to the general concept as I have indicated to some of my friends in the Congress, I think we have to formulate it in a manner which recognizes that monetary policy is always forward looking. And we have to be careful, not to be engaged in a policy which is too rigidly controlled by specific historical numbers.

MARTIN DAVIS: Mr. Chairman, in the past few months, both consumer and producer prices have been falling in Japan. Do you think that more aggressive open market purchases of dollars would stop their deflation?

THE HONORABLE ALAN GREENSPAN: It is certainly true that Japan is really the first major incidence of deflation in the post-World War II world economy. And I would even argue as most Japanese economists would argue, that the official price data that they published, like ours, is over estimated. And as a result of that, they are seeing a fairly significant decline in prices and one need only look at the very low yields in their long-term bond market to accept this as a particular fact. I have not been inclined publically to stipulate what I thought my colleague's policy should and should not be. Stating these things in public, I find rather counterproductive and certainly I would not like my colleagues in other countries to publically stipulate what it is they think we should be doing.

MARTIN DAVIS: It is a private meeting. (Laughter)

THE HONORABLE ALAN GREENSPAN: I am off the record. We do speak to each other at great length all of the time, and I must say, somewhat less facetiously, the very fact that we all talk to each other and exchange views and are in really constant contact, owing to a large extent because world communications is so improved so extraordinarily, we I think are enabled to use all of our experience worldwide, to assist each and every countries policy. So, I would like to answer the questions specifically but I can think of 27 reasons why I shouldn't.

HENRY KAUFMAN: Mr. Chairman, you are a great student of capital spending. And as you know, in this economic expansion, one of the key mainstays has been capital goods and equipment spending. So the question is whether this excellent performance can be sustained or in particular how long would the present economic slowdown have to last before it would have the significant retarding influence on this sector?

THE HONORABLE ALAN GREENSPAN: Henry that is the key question which I think we are all basically confronted with. We are in a period right now which is relatively rare. They don't occur very often, but we are in a type of period where the complexity of the adjustment process depends to a large extent...I shouldn't say the complexity but the outcome...depends on how long it takes to work its way through the system when we have some form of general weak demand which we have seen recently. What we observe at this particular point is a, as you point out, a capital goods market which is moving reasonably well. It is slowing down some in certain areas, in heavy trucks for example, in Class A trucks orders have come down fairly appreciably. In some capital goods area, there has been some weakness, but I think it is true to say that in general, that is probably one of the major stronger parts in our economy. In my judgment, I think that the crucial element here as I said in my prepared remarks, is how rapidly the inventory adjustment process occurs because if it is stretched out, if there is unintended additional inventory accumulation, then I think it, ultimately by holding production down, feeds back into incomes, consumers and others, corporate profits begin to flatten out, and the process of pulling back on capital investment ensues. So I think the major process that we have to focus on in the weeks and months ahead is the issue of how the inventory data are behaving. The last official data we have is for the month of April and that shows only modest reduction in the rate accumulation from the first quarter. However, the anecdotal evidence and I must say some other evidence like inventories in the motor vehicle area, do show that in May and June there has been a significant movement down in inventory investment and one need only look at for example the significant sharp reduction in orders that are coming from metal service centers where both major order declines in aluminum and steel have been evident. So you can see it in the areas where inventories are crucial and the service center is sort of the prototypical type of area where one can see the process functioning. So it looks at this particular stage as though the inventory correction is taking place. It has obviously affected income and employment. The one thing I don’t think anybody knows because I just don’t know any way to look into the future with great perspicacity is whether or not that process will come fairly rapidly, whether it will slow up and the crucial player, in fact, the crucial player in this whole process probably is the capital investment area. Because if profits hold up and capital investment holds up, it is very difficult to maintain weakness in other parts of the economy.

MARTIN DAVIS: Mr. Chairman, the Federal Reserve Boards trade weighted dollar index versus Japan, Canada and the major European nations, indicates that the dollar is far weaker than the more comprehensive Federal Reserve Bank of Dallas Index that includes Mexico and other important developing nations. In assessing U.S. trade and inflation prospects, which dollar indices do you find more relevant?

THE HONORABLE ALAN GREENSPAN: Well I think that we use them both for different reasons. The first, obviously if your basic purpose is to trace the effect of exchange rate changes into import prices, then what you want is an import trade weighted index which reflects all of the various different exchange rates, but I might also add, in real terms. So that if you have a major weakening for example in the Mexico peso visa vie the dollar, you want to recognize the fact that inflation there is accelerated quite substantially. So you have to make that sort of adjustment. But it is true, to get the price, the import price effect, what you want to do is to use something which is very broad like the Dallas Index. But if your interests is in the reserve status of the dollar, and its implications with respect to our international financial position and the financial markets of the United States, then clearly what you want is something which we estimate which is the G10 major countries which gives us a better idea of what the status as a store value by the major countries of the world, how the rest of the world sees the dollar. That is why even though one can readily argue that the dollar has not weakened anywhere near in any of these broad indexes as it has against the Deutsche Mark and especially the yen. It is a mistake to basically assume that the latter is not a relevant consideration. It matters to the status of the United States as a reserve currency because they are our potential currency competitors. And if we are indifferent to those movements because we argue, it doesn't affect the domestic price levels of the United States, which may in fact be true, it does affect the financial flows and therefore has an impact on the American economy which we are required to be very conscious of.

HENRY KAUFMAN: Mr. Chairman, I would like to turn to Mexico a moment. As you know certain officials and market participants in Europe as well as in Japan have expressed reservations about the proposition that Mexico's financial difficulties posed a threat of contagion. Now they claim the Mexican financial crisis was a local matter reflecting conditions specific to Mexico. What are these critics missing in your opinion?

THE HONORABLE ALAN GREENSPAN: In other than the truth. (Laughter) In all seriousness I sympathize with their point of view, it is very difficult for us as central bankers to look at a complex situation such as evolved in Mexico which is a new type of situation in the world. We don't have enough historic precedent and as a consequence cannot say definitively that we know precisely how that type of situation would have created systemic risk, nor I might add can those who take the other position be as strongly positive on that question either. The judgment that I think all of us made in the United States, in the Treasury, in the Federal Reserve and elsewhere, is that there was a sufficiently large concern that we observed in the markets which created a threshold decision on the part of the Treasury to move forward and we at the Federal Reserve supported it. You can never go back and look and say, who was right and who was wrong, because the actions that were taken very largely eliminated what contagion may well have existed. So it is not the type of issue which one can very readily make a judgment on. I spent a good deal of time looking at all of the detailed information that we had from all sources, and I strongly supported what decision was made by the Treasury on the grounds that the risks that were involved if, judgments of contagion were wrong, and there was more there than met the eye, or I think too large to risk the potential consequences that could very well have occurred if that were not handled in the way in which it was.

MARTIN DAVIS: Mr. Chairman, on a lighter note, recent reports indicate that the White House has been sending signals to you to reduce interest rates. Does the recent wave of jawboning in any way tend to compromise the independence of the Fed?

THE HONORABLE ALAN GREENSPAN: Martin, you do wonders for these light questions. First of all, as I have said publically, our relationship with the Secretary of the Treasury, and his predecessor, Senator Benson, has been exemplary as far as I am concerned. They have been very knowledgeable about what we at the Federal Reserve have been doing, and have acted in a manner which I think is the way in which an Administration should function with an independent central bank. We talk to them a great deal, we explain what we are doing, and why, as indeed I think it is incumbent upon any independent institution in a democratic society to do. I assume that we don't always agree and on occasion I assume there are marginal differences, but I must tell you that what has happened essentially is and more in the light vane as you often wonder that when you have an administration picking on the Fed, it is good news for the news people who want something which says, sic em, but the truth of the matter is, they do not. And I think that in that regard I think they have done very well in trying to work with us in integrating both fiscal and monetary policy and I don't know how textbooks will be written about how integration of policy should be, but I will say to you that I have been quite pleased with the way it has functioned in recent years, and I don't say it can't be improved, but the notion that somehow this simplistic jawboning of the Fed just has no factual basis of which I am aware.

JOHN HENNESSY, CHAIRMAN: I think we have time for one more question, Henry.

HENRY KAUFMAN: Well, let us end the way we began then, and I will pose the question differently than my associate. Mr. Chairman, what are the prerequisites that would induce you to propose an easing of monetary policy? (Laughter and applause)

THE HONORABLE ALAN GREENSPAN: Boy you can't win here. I am trying to think of a way to answer that question by putting more words into fewer ideas than I usually do. (Laughter)

Basically let me see if I can try to explain what the basic underlying philosophy of policy is. In the early 60's and 70's or the 60's and 70's, it became very apparent that monetary policy was out of sync with the economy and that as a consequence of always being late in the cycle, it tended to be as many analysts have indicated counterproductive and probably in certain respects exaggerated the business cycle as much as it ameliorated it. In recent years, or more appropriately I would say the last ten or 15 years, there has been an endeavor, especially in the United States and increasingly abroad, to try to move ahead of the curve so to speak, to try to recognize that there is no alternative to endeavoring to make forecasts as best one can make and to try to make policy changes and adjustments in the light of the longer term cyclical pattern, recognizing that so long as human nature is what it is, that there is no way to eliminate the business cycle. All we can expect to do and do effectively is to somehow dampen it. I have said on many occasions before the Congress that the central purpose of monetary policy successfully implemented is to squeeze down the fluctuations as best we can. As a consequence of that, what we try to do is, and have been developing as well as some of our predecessors and compatriots in other countries, is to try to develop a set of policy procedures which can move towards increased stability. The requirement is that we evolve and we will evolve over the years in learning how to make this system work. It is relatively new in the sense that it is a new approach to how central banks function. And I would suspect that we are going to begin to develop techniques of how we function, where we adjust, when we move in certain ways, and under what conditions, which try to capture the effect that monetary policy has effects not only over the longer run, which most of the econometric models demonstrate fairly conclusively. But there are certain types of effects which occur in the early part, immediately upon monetary policy actions to the extent that it effects psychology, and if you don't believe that, just recall when we moved in February 1994, 25 basis points and you would think the world was about to fall apart. So anyone who says that monetary policy only has longer lags has not lived through periods such as that. So I can't answer the question very explicitly, but all I can say to you is that we are trying to focus the policy over the long run to meet what we have stipulated on many occasions as monetary policy which is forward looking and basically endeavors to recognize that the maximum long-term sustainable economic growth requires that you maintain a non-inflationary environment. So on occasions when we tighten or when we ease, we do it in the context of looking, not only at tomorrow or the next day or the next week, but try to recognize that there are certain principles which would build up. I can't basically and wouldn't if I could try to say what I would recommend at the next FOMC meeting, because it is something which I personally do over a period of time in developing policies that I try to recommend and my colleagues try to recommend to me and we get into very interesting discussions. The reason I use the term engaging with respect to the next FOMC is to really underscore the fact that there are very capable people in the Federal Open Market Committee, especially not only our governors who we deal with on a daily basis, but we have very extraordinarily competent presidents of the banks who, when we come in every six weeks, they bring a quality to the discussion which I must say, I, in one sense are glad that we are publishing, even if there are five year lag, our transcripts, because I think you are going to find that the quality of the discussions about what policy should be, and how it does and how it functions when these transcripts finally come out, I think will look pretty impressive and I hope will contribute to a better understanding of new avenues in the development of monetary policy in the years ahead. Thank you very much. It has been a pleasure being here. (Applause)